A **KETUA PENGARAH HASIL DALAM NEGERI**

v.

NV ALLIANCE SDN BHD

B HIGH COURT MALAYA, KUALA LUMPUR
AZIAH ALI J
[CIVIL APPEAL NO: R1-14-04-2009]
20 APRIL 2010

C ***AGENCY:*** *Rights of agents - Commission - Agents paid incentives together with commissions - Incentive payments not included in income tax statements - Effect of - Whether incentive payments are 'entertainment' under the Income Tax Act 1967 - Effect of - Whether deductible from respondent's income - Income Tax Act 1967, s. 18*

D ***AGENCY:*** *Rights of agents - Remuneration - Agents paid incentives as motivation to carry out sales - Whether incentive payments contractual commissions - Whether incentive payments made to promote respondent's business - Factors to consider - Effect of - Whether incentives payments had been gratuitous without consideration - Whether there is element of hospitality*
E *in incentives given - Whether incentives comes under definition of 'entertainment' under Income Tax Act 1967 - Effect of - Income Tax Act 1967, s 18*

REVENUE LAW: *Income Tax - Deduction - Incentive payments - Agents paid incentives together with commisions - Incentive payments not included in*
F *income tax statements - Effect of - Whether incentive payments 'entertainment' under the Income Tax Act 1967 - Effect of - Whether deductible from respondent's income - Income Tax Act 1967, s. 18*

STATUTORY INTERPRETATION: *Taxing statute - Income tax -*
G *Penalty payments imposed by appellant on respondent - Whether appellant correct in imposing penalty - Effect of - Respondent's claim made in good faith - Whether a defence under s. 113(2) Income Tax Act 1967*

STATUTORY INTERPRETATION: *Taxing statute - Income tax - Whether incentive payments are 'entertainment' - Income Tax Act 1967, s. 18*
H *- Whether respondent allowed to make deduction of incentive payments against their income pursuant to s. 39(1) Income Tax Act 1967*

The respondent filed an appeal to the Special Commissioners of Income
I Tax ('SCIT') against tax assessments made by the appellant under the Income Tax Act 1967 ('Act'). The appellant was of the opinion that the expenses/incentives paid by the respondent to their marketing agents to motivate them to increase sales had constituted 'entertainment' within the

meaning of s. 18 of the Act and were thus not allowed to be deducted against the respondent's income pursuant to s. 39(1)(l) of the same Act. The SCIT disagreed and were of the opinion that the expenses incurred by the respondent in the form of incentives had been incurred solely with the object of promoting the respondent's business and thus were revenue in nature and had not been prohibited from deduction against the respondent's income. Thus, the SCIT allowed the respondent's appeal. Dissatisfied with this, the appellant brought the matter before this court. The issue that arose for determination was whether the SCIT had erred in finding that the incentives were not 'entertainment' within the meaning of s. 18 of the Act and whether the 'incentives' had been caught under s. 39(1) of the Act.

Held (allowing the appellant's appeal with costs):

(1) 'Public Ruling No. 3/2004' had no force of law and was not binding on this court. (para 24)

(2) The incentives had been paid through competitions or contests organized by the respondent and it was paid as a reward to those sales agents who achieved their sales targets. Thus, apart from the commissions that the respondents had been contractually bound to pay under the agency agreements, the sales agents were also rewarded for achieving their sales targets. As such, the payment of incentives, although its predominant purpose had been to promote the respondent's business, had also been given or paid to reward those sales agents who achieved their sales targets. Therefore, the incentives were not paid solely for the purposes of promoting the respondent's business. (para 25)

(3) The respondent had not included those incentive payments in the income tax statements of each sales agent, which indicated that the incentive payments had not been part of the contractual commissions paid under the agency agreements but rather as extra payments given to the sales agents over and above the commissions that they had been paid for doing what they had been contractually bound to do under the agency agreements. The agents had not been required to fork out anything extra. Thus, the incentive payments given by the respondent were by nature gratuitous without consideration. There had been an element of hospitality in the incentives given based on the case of *United Detergent Industries Sdn Bhd*. Section 18 of the Act defines 'entertainment' to include 'hospitality of any kind'. Thus, the SCIT had erred when it concluded that the incentives did not come within the meaning of 'entertainment'. (para 26)

(4) The SCIT had made a conclusion that had contradicted their own earlier finding *ie*, that the expenses fell under the definition of 'entertainment' in s. 18, with no explanations given for the same. The SCIT had erred when they ignored their own findings and found that the incentive payments were not caught by s. 39(1)*(l)* of the Act. (para 27)

(5) On the issue of penalty, the SCIT had been of the view that the penalty imposed had been wrong as the claim had been made by the respondent in good faith. Section 113(2) of the Act confers a discretion on the Director General of Inland Revenue whether to impose a penalty after considering all relevant facts. The appellant in this case had found that the respondent had incorrectly claimed certain expenses as deductions from its income. 'Good faith' is not a defence under s. 113(2) of the Act and thus, the penalty imposed by the Director General in the exercise of the discretion conferred by s. 113(2) was correct. (para 28)

Case(s) referred to:

Aspac Lubricants (Malaysia) Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri [2007] 3 CLJ 353 CA ***(refd)***

Margaret Luping & Ors v. Ketua Pengarah Hasil Dalam Negeri [2000] 3 CLJ 409 CA ***(refd)***

United Detergent Industries Sdn Bhd v. Director General of Inland Revenue [1998] 1 LNS 176 HC ***(foll)***

Legislation referred to:

Income Tax Act 1967, ss. 18, 33(1), 39(1)(*l*), 113(2)

For the appellant - Neng Juliana Ismail; Inland Revenue Department
For the respondent - Francis Tan; M/s Azman Davidson & Co

Reported by Sharmini Pillai

JUDGMENT

Aziah Ali J:

[1] The respondent herein filed an appeal to the Special Commissioners of Income Tax ("SCIT") against the following tax assessments made by the appellant under the Income Tax Act 1967 ("the Act") as follows:

Year of Assessment	Date of Notice	Penalty (RM)	Tax Payable (RM)	Additional Tax Payable (RM)
2000	8.11.2005	275,788.30	1,568,423.98	735,435.46
2001	8.11.2005	300,682.27	2,838,534.05	801,819.65
2002	8.11.2005	373,574.88	3,043,887.84	996,199.68

[2] The appellant contends that the expenses/incentives paid by the respondent to their marketing agents to motivate them to increase sales constitute entertainment within the meaning of "entertainment" under s. 18 of the Act and are therefore not allowable as a deduction against the respondent's income pursuant to s. 39(1)(*l*) of the Act. The SCIT disagreed with the appellant's contention. The SCIT is of the opinion that the expenses incurred by the respondent in the form of incentives are incurred solely with the object of promoting the business of the respondent and are thus revenue in nature and are not prohibited from deduction against the respondent's income. By a deciding order dated 22 July 2008 the SCIT unanimously allowed the respondent's appeal.

Background

[3] The issues for determination by the SCIT as set out in para. 2 of the Case Stated is as follows:

(a) whether the following expenses:

No.	Expenses	YA 2000 CY(RM)	YA 2001 (RM)	YA 2002 (RM)
1	Sales target incentives	238,948	87,993	127,295
2	Agency sales competition	180,000	103,710	
3	Quarterly incentives	540,979		
4	Cash incentives to agents	306,154		

(hereinafter referred to as "the expenses") were wholly and exclusively incurred in the production of gross income of the respondent within the meaning of s. 33 of the Act and not restricted under para. 39(1)(*l*) of the Act;

(b) whether the respondent (the appellant herein) is right in law to impose a penalty of 60% on the amount of tax undercharged under sub-s. 113(2) of the Act.

[4] Before the SCIT the respondent contends as follows:

(i) the respondent argued that the cash incentives paid to the agents were wholly and exclusively incurred in the production of their gross income and should be allowed as a deduction under s. 33(1) of the Act and not restricted under s. 39(1)(*l*) of the Act;

(ii) the respondent is also aggrieved with the penalty imposed by the appellant pursuant to s. 113(2) of the Act for the reason that the respondent gave incorrect information or omitting or understating income by claiming the expenses in their return form submitted to the appellant.

[5] The appellant contends as follows:

(i) the appellant did not dispute the fact that the expenses claimed as "incentive" do fall under s. 33(1) of the Act. However the appellant argued the expenses were in the form of entertainment as defined under s. 18 of the Act. Therefore the expenses were not allowable as a deduction against the respondent's income pursuant to s. 39(1)(*l*) of the Act;

(ii) the appellant argued that the Director General is granted power to impose penalty under s. 113(2) of the Act upon a person who makes an incorrect return or gives any incorrect information in relation to the liability to tax. In this case the appellant is entitled to impose such penalty because the respondent had claimed certain expenses under s. 33(1) of the Act which in the opinion of the appellant is disallowed from deduction by virtue of s. 39(1)(*l*) of the Act. It means the respondent has made incorrect return in their Return Form submitted to the appellant

(iii) the expenses claimed are not "additional commission" or even "commission";

(iv) a close examination of the circulars or notices set out will show that in nature they are all competitions or contests organized by the appellant and as such the expenses are payment for the prizes for the contest or competitions;

(v) the only commission the agents will get for carrying out the respondent's bidding are the amount of commission as spelled out under the agency agreement and the Schedule attached thereto;

(vi) the obligation of the respondent to pay to the sales agents under the contractual relationship of contest organizer and contestant is to pay the contest winning or prizes whereas the obligation of the respondent to pay to the sales agents under the agency agreement is to pay the commission;

(vii) in order to be qualified for these 'incentives' or to win, the sales agents are not doing anything more than they would normally do under the agency agreement nor do they have to fork out anything extra and therefore it is obvious that the payment of 'additional commission' or the payment of prizes for the contest or competition are given away gratuitously and without consideration and are entertainment expenses;

(viii) even if the main object of these 'incentives' or contest are to increase sales for the respondent, this alone does not indicate that the expenses are not entertainment expenses.

[6] The SCIT found the following facts (para 6 of case stated):

(i) the appellant was incorporated in Malaysia as a private company limited by shares;

(ii) the appellant is tax resident in Malaysia with its registered office at Penthouse, Menara AA, 247 Jalan Tun Razak, 50400 Kuala Lumpur;

(iii) the appellant is in the business of marketing of burial plots, urn compartments and funeral packages;

(iv) in the course of its business, the appellant needs the services of many marketing personnel and the appellant appointed agents to undertake the marketing functions;

(v) the agents are paid commissions for their job done. Besides that, from time to time the appellant introduced incentives schemes *via* circulars or notices issued by the appellant with the aim of motivating agents to increase sales;

(vi) under the incentive schemes, the agents on achieving set targets are paid or rewarded with various types of incentives such as watches, pens, vases, etc, as well as cash incentives. This appeal only concerns cash incentives;

(vii) the appointment of the sales agents is by way of filling in certain requisite forms and the signing of an agency agreement, a sample copy of which is at pp. 14 to 35 of exh. "B1";

(viii) the consideration to be received by each sales agent under the agency agreement is the payment of a commission as stated in the Schedule to the agency agreement;

(ix) the amount of commission payable under the agency agreement are set out at pp. 33 to 39 of exh. "B1";

(x) the 'incentives' schemes are referred to as sales target incentives, agency sales competition, quarterly incentives and cash incentives;

(xi) to qualify for these 'incentives', the agents had to fulfil certain eligibility criteria which were set out in circulars or notices issued by the appellant, examples of which are as follows:

(a) Van Incentive - Down Payment - 16 May 2000
- p. 83 exh. "E1";

(b) Agency Super Challenge 2000 (amended) - 15 February 2000
- pp. 84 - 85 exh. "E1";

(c) Agency Super Challenge Incentive 2000 - 3 March 2000
- p. 86 exh. "E1";

(d) Van Incentive Scheme - 1l May 2000
- p. 88 exh. "E1";

(e) Agency Super Challenge 2000 (amended) - 15 February 2000
- p. 96 exh. "E";

(f) E. R Bonanza (Amended) - 1 June 2000
- pp. 1 - 2 exh. "E5";

(g) Laptop Incentive - 11 November 2002
- p. 114 exh. "E1";

(h) Agents March Incentive - Notebook Computer - 9 March 2002
- pp. 115 - 116 exh. "E1";

(i) Special FSP Cash Incentive - 8 August 2000
- pp. 125 - 126 exh. "E1";

(j) Agency Super Challenge 2000 (amended) - 15 February 2000
- pp. 127 - 128 exh. "E1";

(k) Special FSP Cash Incentive - 16 January 2001
- pp. 150-151 exh. "E1";

(I) Agency Super Challenge 2001 - 16 January 2001
- pp. 152 - 153 exh. "E1";

(m) Special FSP Cash Incentive - 8 March 2001 A
- p. 154 exh. "E1";

(n) Agency Super Challenge 2001 - 16 January 2001
- p. 159 exh. "E1";

(o) Special FSP Cash Incentive - 20 April 2001 B
- pp. 160 exh. "E1";

(p) Agents March Incentive - 12 March 2001
- pages 161 - 162 Exhibit "E1"; C

(q) Super FSP Cash Incentive II - 4.10.2002
- pages 187 -188 Exhibit "E1";

(r) Nationwide Mid Month Cash Incentive - 14.6.2002
- pages 189 - 190 Exhibit "E1"; D

(s) Nationwide Mid Month Cash Incentive - 15 July 2002
- pp 191 - 190 exh. "E1";

(xii) the field audit on the appellant was carried out by the respondent on 29 November 2004 until 1 December 2004; E

(xiii) the focus of the audit was on the expenses claimed by the appellant especially incentives and promotion expenses;

(xiv) the basis of the focus was that the taxpayer has high gross profit margin but low net profit and therefore there is a need to find out what made it so by focusing on the expenses especially the large amounts which happen to be the appellant's "incentives" and "promotion" expenses; F

(xv) the officer in charge of the field audit on behalf of the respondent was Puan Fazliza Mohd Kasim and the attending officer on behalf of the respondent was Mr Vincent Roo Wing Sum; G

(xvi) it was discovered under the audit exercise that certain items were incorrectly claimed by the appellant as deductible expenses and these items are as set out in para. 4 of the respondent's letter dated 4 March 2005 at p. 328 exh. "E1"; H

(xvii) conclusions arrived at by the respondent whether the expenses were entertainment or not were based on ledger samples, trial balance, income statements and supporting documents, for example, initially, sales target incentives were disallowed based on I

A the appellant's ledger as at p. 106 of exh. "E1". Samples of transactions from the ledger showed that the appellant claimed laptop subsidies and supporting documents for it are at pp. 109 to 116 of exh. "E1";

B (xviii) the expenses claimed clearly falls under definition of entertainment in s. 18 and explanation in Public Ruling 312004 which specifically mentions that "recreation and hospitality would include gifts and give-aways";

(xix) the incentives consists of expenses as set out in the schedule C attached to the tax agent's letter dated 25 April 2005, at p. 253 exh. "E1";

(xx) the notices or circulars relating to the 'incentive schemes' were mostly given by the tax agents after the audit exercise by way of letter dated 26 October 2005 at p. 203 exh. "E1";

D

(xxi) the amount paid as 'incentives' or 'additional commission' to the sales agents had been omitted in the income statement produced to each agent at pp. 447-461 exh. "E2" and in the appellant's accounts it is not classified under commission but incentives;

E

(xxii) nature of agency sales competition and sales competition incentives are the same and even the taxpayer itself is unable to differentiate them as the amount disputed was never reflected in the breakdown;

F (xxiii) for quarterly incentives, based on the ledger at p. 81 of exh. "E1" and samples and supporting document at pp 82 to 85 of exh. "E1", they show that the incentives given were in the form of subsidies of down payment for purchase of motor vehicles and laptop computers for the agents which are not G exchangeable for cash;

(xxiv) the imposition of 60% penalty under s. 113(2) of the Act on the additional tax is pursuant to the field audit discovery that the appellant incorrectly claimed certain expenses as deduction from its income;

H

(xxv) there were difficulties faced by the respondent pursuant to the field audit in determining the amount for each of the expenses such as, the figures in the audited account do not tally with the ones in the trial balance and the general ledger and no I reconciliation was given by appellant. Other than that the classification in the account is not consistent, eg, sales target incentives were classified under "promotion" expenses in the

Year of Assessment 2002 but in the incentives and whatever breakdown that was given by appellant was not reflected in the ledgers as most expenses were provision and not actual. It was also difficult to substantiate or detect the real expenses in the ledger;

(xxvi) all disputed expenses stated in the Form Q were the same in nature but the appellant classified them under different account with different names;

(xxvii) after several discussions and negotiations, some consensus and concessions were achieved between both parties and the assessments were finally raised based on the figures and computation as attached to the respondent's letter dated 27 October 2005 at p. 213 exh. "E1";

(xxviii) the appellant claimed the incentives (cash incentives) paid to agents as the expenses wholly and exclusively incurred in the production of income under s. 33(1) of the Act in their Return Form for Years of Assessment 2000 (current year), 2001 and 2002;

(xix) the respondent disallowed the claim for the reason that the expenses was entertainment as defined under s. 18 of the Act and therefore it was restricted under s. 39(1)(*l*) of the Act;

(xxx) the respondent also imposed 60% penalty under s. 113(2) of the Act for the reason that the appellant has incorrectly claimed certain expenses as deduction from its income;

(xxxi) the respondent raised the additional tax and penalty for the Years of Assessment 2000(CY), 2001 and 2002; and the notices of assessment issued to the appellant on 8 November 2005;

(xxxii) the appellant being dissatisfied with the said assessments, filed notices of appeal in Form Q to the Special Commissioner of Income Tax on 28 March 2006.

Findings Of The SCIT

[7] The SCIT found that there is no dispute on the fact that the amount of the expenses paid out as "incentives" do fall under s. 33(1) of the Act which provides as follows:

> 33. (1) Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person

A from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including -

Therefore the amount of the expenses paid out as "incentives" are allowed as a deduction unless it is caught by s. 39(1)(*l*) of the same B Act, in which case it would not be allowed as a deduction though it is allowable under s. 33(1) of the Act. The SCIT referred to the case of *Margaret Luping & Ors v. Ketua Pengarah Hasil Dalam Negeri* [2000] 3 CLJ 409 as follows:

C In our view, for a taxpayer to qualify for deduction of any payment or expenditure incurred by him he must first of all place the payment or expenditure as allowable under s. 33 of the Act. He has to justify that the payment or the expenditure incurred by him is an allowable deduction under s. 33 of the Act. In the present appeal it is sub-s. (1) of that section. If the payment or expenditure is not allowed under D s. 33(1) of the Act then it would not be allowed as a deduction. On the other hand, if it is allowed as a deduction under s. 33(1) of the Act, one has to proceed to the next step to ascertain whether the payment is caught under s. 39(1) of the Act. If it is caught under s. 39(1) of the Act, then it would not be allowed as a deduction though it is allowable under s. 33(1) of the Act.

E

[8] The SCIT considered the evidence of AW1 and AW2, the executive director of the respondent and the tax agent of the respondent. According to them the income of the agents is in the form of commissions based on performance. The incentives are in the nature of additional remuneration paid to agents who met the sales target. The F reason for introducing the incentives is to motivate agents to work harder to increase the sales of the appellant.

[9] The SCIT formed the view that the expenses incurred are solely with the object of promoting the business by motivating the agents to G work harder to increase sales. The SCIT is of the opinion that the expenses are related to performance of profit earning operations and are wholly and exclusively incurred in the production of the appellant's gross income pursuant to s. 33(1) of the Act and are thus revenue in nature. Therefore the SCIT is of the opinion that the expenses and not H prohibited from deduction by virtue of s. 39(1)(*l*) of the Act before its amendment by Act 631 of 2003. The SCIT disagreed with the appellant that the expenses constitute "entertainment" within the meaning of s. 18 of the Act and are caught by s. 39(1)(*l*) and thus not allowable as deduction in ascertaining adjusted income of the respondent.

I

Appellant's Submissions

[10] The appellant whilst not disputing the fact that the expenses claimed as "incentives" do fall under s. 33(1) of the Act however argued before the SCIT that the expenses claimed clearly falls under the definition of "entertainment" in s. 18 of the Act which provides as follows:

> "entertainment" includes:
>
> provision of food, drinks, recreation or hospitality of any kind; or
>
> (a) the provision of accommodation or travel in connection with or for the purpose of facilitating entertainment of the kind mentioned in paragraph (a);
>
> by a person or an employee of his in connection with a trade or business carried on by that person.

[11] The appellant further refers to 'Public Ruling No. 3/2004' issued by the Director General of Inland Revenue on 8 November 2004 which explains the tax treatment of entertainment expense as a deduction against gross income from a business in relation to s. 18 of the Act and which specifically mentions that "recreation and hospitality would include gifts and give-aways". Rule 3.3 of the said 'Ruling' reads as follows:

> "Recreation and hospitality" would include:
>
> (i) a trip to a theme park or recreation centre;
>
> (ii) a stay at a holiday resort;
>
> (iii) tickets to a show or theatre; and
>
> (iv) gifts and give-aways.

[12] The appellant disputes the respondent's contention that the expenses are commissions or "additional commissions" on the following grounds:

(i) These expenses were amounts incurred by the respondent as "incentives" provided to the sales agents who achieved specific sales target, through certain schemes or competition such as sales target incentives, agency sales competition, quarterly incentives and cash incentives and therefore the agents had to fulfill certain eligibility criteria which were set out in circulars or notices issued by the respondent;

(ii) the respondent only disputes the 'incentives' which are given in the form of cash. "Incentives" in the form of goods are not disputed and the appellant agrees that they are not deductible from its gross income;

(ii) a close examination of the circulars or notices are exhibited in the appellant's bundles of documents show that in nature they are all competitions or contests organized by the respondent in that:

(a) there are rules and regulations;

(b) there are specified closing dates;

(c) winners will be announced and determined by the organizer;

(d) top prizes and consolation prizes are given to winners.

[13] The appellant refers to the evidence of the respondent's witness AW1 who agreed under cross examination that the circulars and notices contain these elements and are in nature contests or competitions and the "incentives" or "additional remuneration" were given to motivate the agents to increase sales. The appellant says that no explanation was given as to why the respondent chose to give these "incentives" or "additional remuneration" through contests or competitions or why the incentive scheme takes the form of contests and competitions.

[14] The appellant also refers to the facts admitted and proved which shows the stand of the respondent that these "incentives" were part of the sales' agents remuneration package. However this stand is inconsistent with the respondent's practice because:

(i) the respondent omitted these "incentives" in the income statement produced to each sales agent;

(ii) did not classify these "incentives" under "commission" but under "incentives" in its accounts.

[15] The appellant submits that the undertakings of the respondent's sales agents in terms of generating sales for the respondent and the entitlement to commissions are contractually entrenched in the agency agreement. The obligation of the respondent to pay and the consideration to be received by each sales agent is the commission under the agency agreement (cl. 5.1). The appellant submits that any alterations or additions to the amount of commission a sales agent is entitled to receive would involve an amendment to cl. 5.1 of the agency agreement but no evidence was led to show that the 'additional commissions' are given pursuant to such an amendment. Therefore to say that the amount given as "incentives" are 'commissions' or 'additional commissions' is contradictory.

[16] In respect of the notices and circulars on the 'incentives' scheme the appellant submits that the relationship is merely one which binds the respondent as an organizer of a competition or a contest and the sales agents as a contestant of the same. The obligation of the respondent to pay to the sales agents under this contractual relationship is to pay the contest winnings or prizes. In order to be qualified for these 'incentives' or to win, the sales agents are not doing anything more than what they would normally do under the agency agreement nor do they have to fork out anything extra. The appellant refers to the case of *United Detergent Industries Sdn Bhd v. Director General of Inland Revenue* [1998] 1 LNS 176 wherein the court considered the meaning of "entertainment" as follows:

> One of the meaning of "entertainment" given by the *Concise Oxford Dictionary*, 9th Ed, is hospitality and "hospitality" according to the Dictionary means the friendly and generous reception and entertainment of guests or strangers. So when one entertains one's guest or a stranger, it is not expected of the guest or the stranger to pay for the entertainment so given. The Shorter Oxford English Dictionary defines "hospitality" as the act or practice of being hospitable, the reception and entertainment of guests or strangers with liberality and goodwill. Similarly, one cannot be said to have entertained one's guest or a stranger with liberality and goodwill if the guest or stranger is made to pay for the entertainment so given. Webster's New Dictionary defines the word to mean the act, practice, or quality of being hospitable, solicitous entertainment of guests. Thus the word "hospitality" connotes the action of entertaining someone without that someone having to subscribe towards the cost incurred by the host for the purpose of entertaining that someone.

[17] The appellant says that in raising the assessment against the respondent it has taken the above meaning into consideration. The appellant submits that it is obvious that the payment of 'additional commission' or the payment of prizes for the contest or competition are "entertainment" expenses as they were given away gratuitously and without consideration. Therefore being "entertainment" the 'additional commissions' and payment of prizes for the contest or competition were caught under s. 39(1)(*l*) of the Act which prior to its amendment *via* the Finance Act 2003 (Act 631) stated as follows:

> 39(1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of:
>
> (a) (not applicable)

A (b) Any expenses incurred in the provision of entertainment including any sums paid to an employee of that person for the purpose of defraying expenses incurred by that person in the provision of entertainment:

Provided that ...

B

[18] In the judgment of Gopal Sri Ram JCA (as His Lordship then was) in the case of *Aspac Lubricants (Malaysia) Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri* [2007] 3 CLJ 353 His Lordship says as follows:

C In my judgment the expenses incurred in respect of the customers' items did not amount to entertainment within s. 39(1)(*l*). In arriving at my conclusion on this point, I find it unnecessary to go further than Romer LJ's judgment in *Bentleys, Stokes & Lawless v Beeson (Inspector of Taxes)* [1952] 2 All ER 82 where he said this:

D ... Was the entertaining, the charitable subscription, the guarantee, undertaken solely for the purpose of the business, that is, solely with the object of promoting the business or its profit earning capacity?

It is as we have said, a question of fact. And it is quite clear E that the purpose must be the sole purpose. The paragraph says so in clear terms. If the activity be undertaken with the object of both promoting business and also with some other purpose... then the paragraph is not satisfied though in the mind of the actor the business motive may predominate ....

F **[19]** It is the appellant's submissions that the SCIT merely considered whether the expenses were incurred solely with the object of promoting the business but ignored the requirements whether the expenses fall under the scope of "entertainment". In making their conclusion, the SCIT had ignored the element of 'hospitality' in the meaning of G "entertainment". The appellant cites the case of *United Detergent Industries Sdn Bhd v. Director General of Inland Revenue (supra)* wherein the court said:

The Special Commissioners had ignored the fact that the said items were not given to the appellant's customers gratuitously and without H consideration, and that they were given only upon the option made by concerned customers. For the reason that the consumer premium items were given away by the appellant to its customers who were wholesalers and retailers, not as a free gift but subject to the payment of the cost incurred by the appellant in the purchasing of the items from its suppliers, and also upon the wishes of the appellant's I customers only in respect of the items, it can no longer be considered as a form of entertainment upon its customers by the appellant. This

is so because there is no hospitality of any kind on the part of the appellant being extended to its customers by charging them the cost incurred in the purchase of the items on their behalf ....

[20] It is submitted that the proper approach that ought to have been adopted is to firstly consider whether the expenses fulfil the requirements of s. 33(1). If the expenses do not, then no deduction is allowed. If the expenses fulfil s. 33(1) the next consideration is whether the expenses come within s. 18 of the Act, ie, whether there is any provision of hospitality of any kind and whether the expenses are incurred in connection with the trade or business.

[21] The appellant submits that the expenses though incurred for the promotion of the business are gratuitous entertainment and this colours the purpose of the respondent incurring the expenses. It is submitted that these expenses were incurred not solely or exclusively for promotion of the respondent's business but also for entertainment. For the reasons above the appellant submits that the expenses incurred are not 'commissions' or 'additional commissions' but payments made to sales agents under the contests and competitions. Therefore such payments are 'entertainment' expenses.

Respondent's Submissions

[22] For the respondent, counsel submits that that the expenses incurred in the form of 'incentives' were for the purpose of promoting the Respondent's business and to motivate and reward the sales agents to achieve higher sales. If the sales agents do not work hard, nothing would be paid. The incentives were paid for work done. It is submitted that the incentive payments were not an act or practice of being hospitable and therefore were not 'entertainment'. Counsel submits that 'Public Ruling No. 3/2004' referred to by the appellant has no force of law.

Decision

[23] The issue for determination is whether the SCIT has erred in finding that the incentives are not 'entertainment' within the meaning under s. 18 of the Act. The appellant does not dispute that the expenses/amount paid out as 'incentives' do fall under s. 33(1) of the Act. The crux of this appeal is whether the 'incentives' are "caught under s. 39(1) of the Act. If it is caught under s. 39(1) of the Act, then it would not be allowed as a deduction though it is allowable under s. 33(1) of the Act." (see *Margaret Luping & Ors v. Ketua Pengarah Hasil Dalam Negeri, supra*).

[24] The appellant however says that the payments made to the sales agents under the contests or competitions are "entertainment" expenses and are not deductible against the gross income of the respondent as these expenses falls within the definition of "entertainment" in s. 18 of the Act and the explanation in Public Ruling 3/2004 which specifically mentions that "recreation and hospitality would include gifts and give-aways". Therefore the incentives being "entertainment" were caught under s. 39(1)(*l*) of the Act which prior to its amendment *via* the Finance Act 2003 (Act 631) reads as follows:

> 39(1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of:
>
> (c) (not applicable)
>
> (d) Any expenses incurred in the provision of entertainment including any sums paid to an employee of that person for the purpose of defraying expenses incurred by that person in the provision of entertainment:
>
> Provided that ....

I agree with counsel for the respondent that 'Public Ruling No. 3/2004' referred to by the appellant has no force of law. It is not binding on this court.

[25] In order to determine whether the 'incentives' come within the meaning of 'entertainment' under s. 18 of the Act, I refer to part of the judgment of Romer LJ in *Bentleys, Stokes & Lawless v Beeson (Inspector of Taxes)* cited in the case of *Aspac Lubricants (Malaysia) Sdn Bhd v KPHDN (supra)* as follows:

> ... that the purpose must be the sole purpose ... If the activity be undertaken with the object of both promoting business and also with some other purpose ... then the paragraph is not satisfied though in the mind of the actor the business motive may predominate ...

In the present case the incentives are paid through competitions or contests organized by the respondent where there are rules and regulations, there are specified closing dates, winners will be announced and determined by the respondent and top prizes and consolation prizes are given to winners. The incentives are paid as a reward for those sales agents who achieve the sales targets. Therefore apart from the commissions that the respondent is contractually bound to pay under the agency agreements, the sales agents are rewarded for achieving sales targets. It is therefore apparent that the payment of incentives, though

with the predominant purpose of promoting the respondent's business, was also given or paid to reward those sales agents who achieve the sales targets set. Therefore the incentives were not paid solely for the purpose of promoting the respondent's business.

[26] Further the respondent does not include these incentives in the income statement of each sales agent. This indicates that the incentives were not part of the contractual commissions paid under the agency agreements. I agree with the appellant that these incentives are extra payments given to the sales agents over and above the commissions that they are paid for doing what they are contractually bound to do under the agency agreements. The agents are not required to fork out anything extra. Thus the incentive payments given by the respondent are by nature gratuitous without consideration. I find that there is the element of hospitality in the incentives given based on the case of *United Detergent Industries Sdn Bhd v. Director General of Inland Revenue (supra)* cited by the appellant where the court said:

> ... the word "hospitality" connotes the action of entertaining someone without that someone having to subscribe towards the cost incurred by the host for the purpose of entertaining that someone.

Section 18 of the Act defines 'entertainment' to include "hospitality of any kind". Having considered the facts, I find that the SCIT has erred when it concluded that the incentives do not come within the meaning of 'entertainment'.

[27] Further I note that at para. 6 of the case stated the SCIT has stated as follows:

> As a result of the evidence adduced before us, both oral and documentary, we found the following facts:
>
> (xviii) The expenses claimed clearly falls under definition of entertainment in section 18 and explanation in Public Ruling 3/2004 which specifically mentions that "recreation and hospitality would includes gifts and give-aways"

However at p. 18 of the case stated the SCIT said:

> ... we are of the opinion that the expenses are relating the performance of profit earning operations would be of a revenue nature. We cannot agree with the Respondent that the expenses are constitute as an entertainment within the meaning of section 18 of the Act; and therefore not allowable as deduction in the ascertaining of adjusted income pursuant to section 39(1)(*l*) of the Act.

A In view of the above facts, we are of the opinion that the expenses in this appeal were wholly and exclusively incurred in the production of the Appellant's gross income pursuant to section 33(1) of the Act and not prohibited from deduction by virtue of section 39(1)(*l*) of the Act before its amendment by Act 631 of 2003.

B From the above it appears that the SCIT has made a conclusion that contradicts their own earlier finding. There is no explanation why their conclusion is contradictory to their earlier finding that the expenses 'clearly falls under definition of entertainment in s. 18'. The special commissioners had erred when they ignored their own findings. Having C considered the submission of the parties, I agree with the appellant that the SCIT has erred in concluding that the incentive payments are not caught by s. 39(1)(*l*) of the Act.

[28] On the issue of penalty, SCIT was of the view that the penalty imposed was wrong as the claim was made by the respondent in good D faith. Section 113(2) of the Act confers a discretion on the Director General of Inland Revenue whether to impose a penalty after considering all relevant facts. In this case the appellant finds that the respondent has incorrectly claimed certain expenses as deductions from its income. I agree with the appellant that 'good faith' is not a defence under E s. 113(2) of the Act. Therefore the penalty imposed by the Director General in the exercise of the discretion conferred by s. 113(2) is correct. For the aforementioned reasons the appeal is allowed with costs of RM3,000 to the appellant.

F

G

H

I